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TAGS: ECON EFIN IS
SUBJECT: ISRAEL HIKES INTEREST RATE TO HEAD OFF INFLATION
AS ECONOMY IMPROVES

Classified By: Economic Counselor David R. Burnett; reasons 1.4 b/d

¶1. (SBU) Amid intense Israeli and international speculation, the Bank of Israel (BoI) became the first central bank to raise interest rates since initial signs of a global recovery. The August 24 hike of 0.25 percent brings the BoI's benchmark rate to 0.75 percent, up from 0.50 percent where it had been since March 2009. BOI Governor Stanley Fischer moved quickly to fight signs of inflation, signaling to the market that for the BOI, maintaining price stability supersedes all other considerations. Though it was widely anticipated that Israel would raise its interest rate sooner than most other central banks, Fischer's move increased his stature as a trailblazer, and the "elder statesman of the global central banking community," as he was deemed by an August 24 Financial Times article. Against this backdrop, recent economic data indicate that after two quarters of contraction, the Israeli economy has reached a turning point and is moving toward recovery. End Summary.

Inflation Trumps Exchange Rate Levels

¶2. (U) The Bank's decision to increase interest rates stemmed mainly from the desire to curb inflation to the target 1-3 percent range. The CPI increased by 2.9 percent in the first seven months of 2009, with two percent of the increase coming in June and July alone. While a significant amount of the July CPI figure was due to one-off items intended to increase tax revenues such as the one percent increase in VAT and increased taxes on cigarettes and cars, the Bank noted in its announcement that inflation was close to the upper end of the range. The Bank acknowledges the difficulty of trying to balance inflation control with the need to increase economic activity, especially as unemployment is expected to climb further in the next few months. However, they believe that the 0.75 percent interest rate strikes this balance.

¶3. (C) Some in the business sector, notably Shraga Brosh, President of the Manufacturers' Association, criticized the decision to raise rates, opining that the harm caused by even a slightly higher rate to Israeli exports, growth and jobs far outweighs negligible inflation. Others praised the action, noting the relatively mild recession in Israeli and the combination of improving growth alongside developing inflation. Finance Minister Yuval Steinitz, in an August 25 radio interview, said that the rate increase was logical and expected, but did not warrant such avid attention as its impact on exchange rates, growth and employment will be minimal. In an August 20 meeting with Econoffs and Treasury rep, Dr. Akiva Offenbacher, the Director of Monetary Policy at the BoI, also noted that the timing of a rate hike was rather immaterial. He does not view inflation as a concern

for the next year to 18 months, and opined that the interest rate would be increased further. While the BoI has given no formal hint as to whether it will continue to raise rates, expectations (the recent strengthening of the shekel this week) clearly favor another hike before the end of the year. However, this will depend on CPI figures, the exchange rate, as well as broader global economic trends.

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BoI will continue to bolster the dollar as needed
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¶4. (C) In recent weeks, the Bank has taken a detour from its very active involvement in the foreign exchange market, part of the bank's strategy since March 2008 to bolster the dollar relative to the shekel. On August 3, the BoI announced it would continue buying USD 100 million a day in the FX market, but in addition would intervene in the event of "unusual movements in the exchange rate which are inconsistent with underlying economic conditions, or when conditions in the foreign exchange market are disorderly." After the announcement and further BoI involvement in the market, the dollar steadily rose to NIS 3.93. A week later, the BoI announced it would discontinue the daily USD 100 million purchase, but continue market intervention as needed. In an August 19 meeting with Econoffs and Treasury rep, Andrew Abir, Head of the Finance Division's Market Operations Department at BoI, explained that the Bank is looking to shift from regular dollar purchases to less transparent or predictable interventions that will have greater impact on exchange rates. Some economists noted that the BoI will have to continue its foreign exchange purchases to the extent that

it seeks to maintain the weakness of the shekel to support exporters and economic growth. Industry reporting indicates that the Bank purchased about USD 50 million prior to the interest rate announcement on August 24 and a similar amount on August 25. There has also been strong criticism of the Bank's intervention policy, with some economists concerned about potential inflationary side effects and others simply opposed to the idea of the BoI aspiring to influence the dollar/shekel rate.

The Economy Appears to Rebound

¶5. (SBU) GDP grew by one percent in the second quarter, after two quarters of contraction. The primary drivers of growth were private and public consumption, which grew by 4.4 percent and 20.2 percent respectively. The sharp increase in public consumption follows a decline of 5.6 percent in the first quarter, with public spending capped at one-twelfth of the 2008 budget per month in the first months of 2009, due to lack of an approved budget. Exports increased by 5.8 percent in the second quarter after declining sharply by 36.2 percent in the fourth quarter of 2008 and by 27.2 percent in the first quarter of 2009. Although the overall picture is positive, there are a few components that buck the trend and make it difficult to define the extent of the return to economic growth. GDP per capita remained negative in the second quarter, although declining less than the first quarter. Domestic investment continued the decline of the previous four quarters. Investment in fixed assets registered a decline of 10.3 percent in the second quarter, following a decline of 11 percent in the first quarter of ¶2009.

¶6. (SBU) The Bank of Israel's State-of-the-Economy Index (S-index), which is an indicator of business activity, rose by 1.2 percent in July. The indices of May and June were adjusted upwards, and were the first positive indices since June 2008. All components show positive trends -- manufacturing, trade and services, service exports, goods exports, and imports -- indicating "a turnaround reflected in

an increase in economic activity" according to the BoI. Bank Hapoalim's consumer index rose in July for the fourth consecutive month, which the bank's economists attribute to the rebounding of the financial markets and a low interest rate encouraging consumption and asset purchasing. Housing statistics indicate a return to real estate purchases, and the leading index of the Tel Aviv Stock Exchange (TASE), the TA 25, has increased 53 per cent since January 2009. On August 25, the TA 25 exceeded the 1,000 mark for the first time since the collapse of Lehman Brothers in September 2009.

¶7. (SBU) Unemployment statistics for the second quarter, released August 27, show an increase from 7.6 percent in the first quarter to 8 percent. While several economists and contacts at the Ministry of Finance are disturbed by the trend, they all noted the lagging nature of unemployment and expect that by year's end the gains in the larger economy will also be evident in the labor market.

¶8. (SBU) Assessments of the current state of the economy from local leading commentators highlight the relative mildness/brevity of the domestic recession due to Israel's strong underlying fundamentals, but many caution that the strength of the local recovery will depend heavily on a global recovery. Optimism prevails, with2010 GDP growth forecasts ranging between 2-3 pecent, powered by a rise in high tech exports as ell as sustained consumption and government spending. Finance Minister Steinitz and his Director General presented an economic survey to the cabinet on August 23, the first in a new series of regular quarterly surveys. The Minister cited several government actions that served to bolster the economy -- formulation of an economic plan, approval of a two-year budget, a package deal between the government and the labor federation, Histadrut -- and noted the positive benefit of stability that these actions contributed to recent economic improvements. He also cited the effect of guarantees to exporters, bank guarantees, credit funds to SMEs, as well as billions of shekels of government investment in infrastructure and R&D. He warned of the need to maintain budget discipline if true growth is to return, noting the increasing debt-to-GDP ratio, which is forecast at 84 percent for 2009.

¶9. (C) Comment: Timing aside, the interest rate increase was largely expected and confirms continued activism by Bank

of Israel. Maintaining the balancing act of curbing inflation while also keeping the shekel weak enough to boost exports will require continuing intervention, but Bank of Israel officials privately indicated to Econoffs and Treasury rep that they do foresee enough signs of recovery by the end of the year to cease constant intervention in the foreign exchange market. The recently published national accounts data provide everyone with a victory to crow over, bolstering the Finance Minister's job approval ratings as well as those of the Prime Minister. With the lull provided by the two-year budget, there is time for the fiscal due diligence that the Finance Minister encourages. Many of our contacts in the Prime Minister's National Economic Council, the Bank of Israel, and the Ministry of Finance are hard at work on a consensus formula for a new fiscal rule that will ensure the necessary discipline (septel).

CUNNINGHAM